Chapter 21 - Practice Questions

1. A hedge ratio of 0.70 implies that a hedged portfolio should consist of
   A) long 0.70 calls for each short stock.
   B) short 0.70 calls for each long stock.
   C) long 0.70 shares for each short call.
   D) long 0.70 shares for each long call.
   E) none of the above.

2. Higher dividend payout policies have a _____ impact on the value of the call and a _____ impact on the value of the put.
   A) negative, negative
   B) positive, positive
   C) positive, positive
   D) negative, positive
   E) zero, zero

3. Which one of the following variables influence the value of options?

   I) Level of interest rates.
   II) Time to expiration of the option.
   III) Dividend yield of underlying stock.
   IV) Stock price volatility.
   A) I and IV only.
   B) II and III only.
   C) I, II, and IV only.
   D) I, II, III, and IV.
   E) I, II and III only.

4. Since deltas change as stock values change, portfolio hedge ratios must be constantly updated in active markets. This process is referred to as
   A) portfolio insurance.
   B) rebalancing.
   C) option elasticity.
   D) gamma hedging.
   E) dynamic hedging.

5. Relative to European puts, otherwise identical American put options
   A) are less valuable.
   B) are more valuable.
   C) are equal in value.
   D) will always be exercised earlier.
   E) none of the above.

Use the following to answer questions 6-8:

An American-style call option with six months to maturity has a strike price of $35. The underlying stock now sells for $43. The call premium is $12.

6. What is the intrinsic value of the call?
   A) $12
   B) $8
   C) $0
   D) $23
   E) none of the above.

7. What is the time value of the call?
   A) $8
   B) $12
   C) $0
   D) $4
   E) cannot be determined without more information.

8. If the risk-free rate is 6%, what should be the value of a put option on the same stock with the same strike price and expiration date?
   A) $3.00
   B) $2.02
   C) $12.00
   D) $5.25
   E) $8.00

Answer Key

1. C
2. D
3. D
4. E
5. B
6. B
7. D
8. A